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REPORT ON THE EFFECTS OF MERGERS IN THE DEFENSE INDUSTRY

Submitted In Compliance With Section 826
National Defense Authorization Act
For Fiscal Year 1997
(Public Law 104-201)

Office of the Secretary of Defense
March 1997

INTRODUCTION

Defense procurement outlays in constant dollars, i.e., adjusted for inflation, have declined 61 percent from 1987 to 1998.[1] This decline has lowered contractor revenues and increased their excess capacity. Companies have responded to these developments in predictable ways - reducing employment, closing facilities, reengineering processes to become more efficient, developing closer relations with their suppliers, and pursuing merger and acquisition opportunities.

Section 826 of the National Defense Authorization Act for Fiscal Year 1997 requires the Secretary of Defense to conduct a study on mergers and acquisitions in the defense sector. It specifies that the study shall address:

- the effectiveness of defense mergers and acquisitions in eliminating excess capacity within the defense industry;
- the degree of change in the dependence by defense contractors on defense-related Federal contracts within their overall business after mergers;
- the effect on defense industry employment resulting from defense mergers and acquisitions occurring during the three years preceding the date of the enactment of this Act; and
- the effect on competition for defense contracts.

THE EFFECTIVENESS OF DEFENSE MERGERS IN ELIMINATING EXCESS CAPACITY WITHIN THE DEFENSE INDUSTRY

Mergers and acquisitions in the defense industry have helped to reduce excess capacity. "Excess capacity" means unused or underutilized floor space and capital equipment.[2] Excess capacity in the defense industry raises the average costs of production and thus raises the cost of the product to the Department. Thus, both the companies and the Department benefit by reductions in excess capacity.

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[1] *National Defense Budget Estimates for FY 1998*, Office of the Undersecretary of Defense (Comptroller), March 1997, Table 6-11.

[2] Actual measurement of excess capacity is difficult because it involves making judgments about manufacturing processes and potential throughput. Standardizing data across firms and industries is difficult. Moreover, many developments may occur simultaneously - increases/decreases in production, awards of new contracts, and development of new products - which make separating the effects of mergers and acquisitions particularly difficult.

Mergers and acquisitions are a means of reducing excess capacity as the resulting defense firm closes less efficient production facilities and consolidates workload into more efficient facilities. Increased capacity utilization following workload consolidation generally results in both lower unit prices and lower overhead rates to the Department.

In addition to any reduction of excess capacity in production resulting from a merger or acquisition are cost savings in the form of reductions in other corporate and segment overheads. Following a merger or acquisition, cost savings are often generated by combining certain administrative functions such as personnel, legal, and accounting and finance functions. Such reductions translate into cost savings for the government through direct reductions in overhead rates.

Reductions in the defense budget have clearly increased defense industry excess capacity since companies do not reduce capacity instantaneously when business declines, nor is it optimal for companies to match business declines with capacity reductions one-for-one. There are nonetheless several indicators that point to the conclusion that mergers and acquisitions in the defense industry have helped to reduce excess capacity and overhead.

First, the Department has reviewed, audited, and certified restructuring plans associated with five mergers and acquisitions, as required by Section 818 of the National Defense Authorization Act for Fiscal Year 1995. A sixth transaction was reviewed prior to enactment of the audit and certification requirements of Section 818. These reviews indicate increased utilization of the assets of the companies involved; all six mergers and acquisitions involved shifting work among facilities. The Department's share of the projected savings from these mergers and acquisitions, after allowance of restructuring costs, is approximately $3.23 billion over a five-year period.[3]

Additionally, the Department recently surveyed the top 50 defense manufacturers on capacity utilization and the effect of mergers.[4] Many of the mergers and acquisitions have occurred too recently to have an effect on capacity utilization; however, in a number of transactions where data was available, companies reported that the merger or acquisition resulted in an increase in capacity utilization, as shown on the following chart:

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[3] On a net present value basis. These figures include only savings for a five-year period; however, savings are expected to continue beyond the five-year period.

[4] Responses were received from approximately 60 percent of the companies surveyed, including the top ten defense contractors ranked by revenue. Responses were not audited or otherwise corroborated.

Effect on DoD-Related Capacity Utilization of
Several Mergers and Acquisitions[5]

Transaction	Party 1 (Pre-Acquisition)	Party 2* (Pre-Acquisition)	Combined (Post-Acquisition)
A	90%**	85%	95%**
B	92%	94%	94%
C	90%	88%	94%
D	96%**	37%	98%**
E	92%	85%	93%
F	90%**	60%	95%**

* "Party 2" refers to the entity acquired in an acquisition; in a merger, it refers to one of entities involved in the merger

** Capacity utilization for Party 1 for the business units involved in the acquisition prior to the acquisition, and for the combined business unit after the acquisition, rather than for the entire company.

CHANGE IN THE DEPENDENCE BY DEFENSE CONTRACTORS ON DEFENSE-RELATED FEDERAL CONTRACTS AFTER MERGERS

The evidence suggests that recent merger and acquisition activity has caused little change in the degree of dependence on defense-related contracts among defense contractors.

Some large Fortune 100 companies (GE, IBM, Ford, Chrysler, Westinghouse, Unisys, Rockwell, Texas Instruments, General Motors, to name a few) have clearly decreased their dependence on defense contracts by means of a divestiture of part or all of their defense business. These divestitures appear to result from a desire to focus on core competencies, a perception that companies require a critical mass involving a breadth of programs and markets and technical skills to be successful in the defense arena, and on reduced valuations in the market for most companies operating both diverse commercial and defense businesses.

Other defense-oriented companies have not sought to exit the defense sector. Many have, however, become less dependent on defense business as their total defense sales have declined in recent years and their commercial sales have remained constant or increased. For others who have merged with or acquired a defense-related company, the

[5] Because the survey responses involve confidential commercial information, they are masked for presentation.

degree of defense dependence of the two parties to the transaction was similar, so the new entity's dependence on defense sales is much the same as for the two predecessor entities. In still other transactions, large companies with a lower percentage of defense work acquired smaller companies with a high percentage of defense work. Because of the relative size of the two parties, the post-transaction dependence on defense sales was not much greater than before the transaction.

THE EFFECT ON DEFENSE INDUSTRY EMPLOYMENT RESULTING FROM DEFENSE MERGERS AND ACQUISITIONS

In the past 10 years, the decline in defense purchases has had a significant effect on industry employment, independent of merger or acquisition activity. In 1987, 3,665,000 workers were employed in the defense industry -- more than in any year since 1953. Since then, the number has fallen each year, and in 1998 it is projected to reach 2,050,000, a 44 percent drop from its peak level.[6]

It is difficult to isolate the effects of mergers and acquisition in this reduction. Employment changes can occur for a variety of reasons, including reductions in business and increased productivity. To isolate the effect of mergers and acquisitions from other factors that may result in employment reductions would require one to surmise what actions the company would have taken had the merger or acquisition not occurred.

Responses to the Department's survey indicated that employment reductions from restructurings that were *independent* of mergers and acquisitions were approximately twice as large as employment reductions resulting from mergers. In addition, one might also assume that at least some of the survey respondents may have attributed employment declines following a merger or acquisition exclusively to that merger or acquisition, whether or not the employment declines would have occurred in any event.

THE EFFECT ON COMPETITION FOR DEFENSE CONTRACTS

The effect of mergers and acquisitions in the defense sector on competition for defense contracts depends on both the number of potential bidders for defense contracts and the quality of that competition. To date, mergers and acquisitions have not adversely affected competition for defense contracts.

Three factors should be considered in evaluating the effect of mergers or acquisitions on the number of bidders in a competition. First, there is no decrease in the number of potential bidders unless both parties to the transaction were potential bidders.

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[6] *National Defense Budget Estimates for FY 1998,* Office of the Under Secretary of Defense (Comptroller), March 1997, Table 7-6.

Second, the number of bidders in a competition may increase if the capabilities of the new entity lead it to bid where the pre-merger entities would not have done so. Third, in some cases, where the number of competitors is reduced, other firms may be able to enter if the procurement is sufficiently far in the future.

It is also important to analyze the effect of a merger on the quality of competition. In some cases, a business combination actually will strengthen the capabilities of weaker firms in a procurement, thus strengthening the competitive environment. In other cases, a reduction in the number of competitors may have no significant effect on competition, because an adequate number of suppliers remain, insuring continued pressure for technological innovation and price competition.

Evaluating the effect of a particular merger or acquisition on competition therefore requires a careful, thorough review of the various programs where the two companies involved are competing or are likely to compete in the future. Within the Department of Defense, that review process is established by DOD Directive 5000.62 (included in Appendix A).

DOD reviews three potential competitive effects of a merger or acquisition: horizontal, vertical, and organizational conflicts of interest. Horizontal competition refers to those programs or markets where the parties to the merger would be direct competitors in future procurements, either individually or as part of competing teams. Vertical integration can affect competition if one party to a merger or acquisition is a key supplier to competitors of the other party, or if the combined entity will "make" components rather than "buy" them from external suppliers. Organizational conflicts of interest may affect competition where one of the parties is providing a systems integration or technical assistance function that may lead to the selection of the other firm as a DoD supplier.

The Department of Defense review examines each of these possible effects and provides that information to the federal antitrust agency, either the Antitrust Division of the Department of Justice or the Federal Trade Commission, depending on the transaction. The Department of Defense has reviewed more than twenty mergers or acquisitions in the defense industry over the past several years. In a number of these cases, after consultation with the Department of Defense, these agencies have required consent decrees with the acquiring party in an acquisition, and with both parties to a merger, to preserve competition. These consent decrees have, for example, required firewalls to protect proprietary information, agreements not to enforce exclusive teaming agreements, or divestiture of business units

In the course of these reviews, two issues emerged deserving greater attention. The first is vertical integration, an area where there is very little agreement among antitrust lawyers and economists, but which was important to the Department partly as a result of concerns that defense industry consolidation might lead companies to favor their internal capabilities when they decide whether to make components in-house or to subcontract with an outside supplier. The second was the overall effect of industry

consolidation, apart from an individual merger or acquisition.

To address the vertical integration issue, the Department asked the Defense Science Board, an advisory body to DoD, to form a Defense Science Board Task Force on Vertical Integration and Supplier Decisions. The report of this Task Force is expected this Spring.

To address the overall effects of industry consolidation and restructuring to date, the Department is conducting a study to analyze the effects on industrial performance, including financial performance, productivity, and employment, to identify the savings to the Department of Defense attributable to defense industry restructuring, and to examine and identify the degree of competition available for major future defense programs in the major markets of defense equipment. We also plan to complete this study this Spring. Both studies will be made public.

CONCLUSION

Mergers and acquisition in the defense industry are a response to the 61 percent decline in constant dollar, i.e., adjusted for inflation, procurement outlays from 1987 to 1998. Mergers and acquisitions play an important role in elimination of excess capacity, thereby reducing the cost to the government. They appear to have little effect on dependence by defense contractors on defense-related contracts. They reduce defense industry employment, but the employment reduction implied by the defense downturn occurs in large measure without mergers and acquisitions. Finally, they have little adverse effect on competition for defense contracts, in part due to the actions taken by the Department of Defense and the antitrust agencies in particular cases to maintain competition. The Department is currently sponsoring or conducting two studies relating to the effects of defense mergers and acquisitions which will be released later this Spring.

Appendix A

Department of Defense
DIRECTIVE

October 21, 1996
NUMBER 5000.62

GC, DoD

SUBJECT: Impact of Mergers or Acquisitions of Major DoD Suppliers on DoD Programs

References: (a) Deputy Secretary of Defense Memorandum, "Antitrust Aspects of Defense Industry Consolidation," May 10, 1995 (hereby canceled)
(b) Title 10, United States Code

A. PURPOSE

This Directive:

1. Supersedes reference (a).

2. Establishes policy and assigns responsibilities for assessing the potential impact on DoD programs that might result from a proposed merger or acquisition involving a major defense supplier.

B. APPLICABILITY AND SCOPE

This Directive applies:

1. To the Office of the Secretary of Defense, the Military Departments, the Chairman of the Joint Chiefs of Staff, the Combatant Commands, the Inspector General of the Department of Defense, the Defense Agencies, and the DoD Field Activities.

2. Only to provide internal guidance to DoD officials, and does not establish an independent basis for any person or entity to assert a right, benefit, or privilege.

C. DEFINITIONS

1. Antitrust Agencies. The Antitrust Division of the Department of Justice and the Federal Trade Commission.

2. Major Defense Suppliers. Any prime contractor or subcontractor that the Secretary of Defense designates as a major defense supplier. The following classes of contractors are considered major defense suppliers without further designation:

a. Any current prime contractor of a major system as defined in subsection 2302(5) of 10 U.S.C. (reference (b));

b. Any current prime contractor, under a contract awarded pursuant to subsection 2304(c)(3) of reference (b), for reasons described in clause (A) of that subsection.

D. POLICY

It is DoD policy to:

1. Assess the potential implications for DoD programs resulting from a merger or acquisition involving a major defense supplier. The assessment shall consider the potential loss of competition for DoD contracts and subcontracts, estimated cost savings or cost increases for DoD programs that can be expected to result from the merger or acquisition, and any other factor resulting from the proposed merger or acquisition that may adversely affect the satisfactory completion of a DoD program.

2. Cooperate with the responsible antitrust agency in that agency's review of a proposed merger or acquisition. Significant implications for DoD programs that are relevant to the responsibilities of the antitrust agencies shall be communicated in the manner specified in this Directive to the antitrust agency responsible for reviewing the proposed merger or acquisition.

3. Ensure reviews are conducted in accordance with the enclosure.

E. RESPONSIBILITIES

1. The General Counsel of the Department of Defense shall:

a. Perform the legal analysis of the impact on the Department of Defense of a particular merger or acquisition and coordinate the legal aspects of the Department's position related to such merger or acquisition.

b. Coordinate contacts between DoD personnel and the government agency responsible for reviewing the antitrust aspects of the merger or acquisition.

2. The Under Secretary of Defense for Acquisition and Technology shall act on behalf of the Secretary of Defense under

this Directive and may designate a "major defense supplier" on behalf of the Secretary of Defense.

3. The Under Secretary of Defense for Acquisition and Technology and the General Counsel of the Department of Defense together may issue DoD Instructions and Publications that implement this Directive.

4. The Deputy Under Secretary of Defense for Industrial Affairs and Installations, under the Under Secretary of Defense for Acquisition and Technology, shall conduct an impact analysis of a particular merger or acquisition on the Department of Defense and coordinate the antitrust review within the Department; and shall consult, as appropriate, with other Under Secretary of Defense for Acquisition and Technology (USD(A&T)) offices and Defense Agencies on the effects of mergers or acquisitions.

5. The Deputy Under Secretary of Defense for Industrial Affairs and Installations, under the Under Secretary of Defense for Acquisition and Technology, and the General Counsel of the Department of Defense, working in coordination with each other, shall identify any impact on national security and on defense industrial capabilities of a proposed merger or acquisition, and advise the Secretary and Deputy Secretary of Defense and the USD(A&T) of that impact.

6. The Secretaries of the Military Departments and the Directors of the Defense Agencies with acquisition responsibility, under OSD Principal Staff Assistants and those that report directly to the Secretary or Deputy Secretary, shall:

a. Ensure that personnel within their respective components comply with this Directive.

b. Ensure that personnel within their respective components are advised that, unless they have been delegated specific authority for this purpose, they are not authorized to communicate to the antitrust agencies, to the media, to the parties involved, or to any other person, the DoD position on the impact that a particular merger or acquisition will have on national security.

F. EFFECTIVE DATE

This Directive is effective immediately.

John P. White
Deputy Secretary of Defense

Enclosure
Review Protocols

REVIEW PROTOCOLS

A. Upon notice of a prospective merger involving a major defense supplier, either from the antitrust agencies, or directly from a defense supplier, the Deputy Under Secretary of Defense for Industrial Affairs and Installations (DUSD(IA&I)) and the General Counsel of the Department of Defense (GC, DoD) shall:

1. Analyze the potential impact of the merger on DoD programs;

2. Coordinate with the responsible antitrust agency; and

3. Advise the Secretary and Deputy Secretary of Defense and the USD(A&T) of that potential impact.

B. DoD personnel shall respond promptly to requests from the DUSD(IA&I) or the GC, DoD, for assistance in connection with the analysis of the impact of a proposed merger or acquisition on a DoD program for which they are responsible.

C. When requested by the GC, DoD, or the DUSD(IA&I), DoD personnel shall provide to the responsible antitrust agency factual information, such as plans for DoD purchases and sources of supply for particular defense products, relevant to the review being conducted by the antitrust agency. All communications from DoD personnel in response to requests received directly from an antitrust agency shall be coordinated with the GC, DoD, and the DUSD(IA&I).

D. The DUSD(IA&I) and the GC, DoD, or their designees, are the DoD officials designated to receive comments from the parties involved in the merger or acquisition or from any other entity that may have information on the impact of a proposed merger or acquisition on DoD programs. A party desiring to convey such information to other officers or employees of the Department of Defense shall be referred to the GC, DoD, or the DUSD(IA&I), or their designees.

E. The Department of Defense's final position on the impact of a merger or acquisition on the Department of Defense and on the defense industrial capabilities shall be determined and communicated to the antitrust agencies and the media only by the Secretary of Defense, the Deputy Secretary of Defense, the

USD(A&T), or the GC, DoD, or their designees. Communication of such a determination in connection with litigation shall be made only through the GC, DoD, or a designee of the GC, DoD.